Establishing Prudent Investment Practices and Strategies During Difficult Times

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What are the Difficult Times?

- Low interest rate environment (but going up)
  - Yield challenge may encourage ill-conceived risks
  - Rising rates will reduce market values
- State take-away of local revenues (getting worse in the short-term)
  - Lower revenues hurt cash flow
- Bad economy (for some in recent years, but getting better)
  - Lower revenues, continued

Practical Pointers

- Restructuring Portfolio
  - Strategy for balancing liquidity and yield to minimize market risk
  - Performance goals and benchmarks
  - Impact on interest income
- Adding investments when rates are rising
- Cash flow impact of State Budget in 2004/05
  - Governor’s Proposal vs. “No Cuts” World

Warning from the Surgeon General:

Your Mileage May Vary!

Investment Players in Fairfield

- LAIF
  - Old stand-by, more short-term than it used to be, liquid, safe, convenient
- City Staff
  - Conservative buy and hold approach with the usual suspects/instruments, limited staff time available
- Investment Managers
  - Active management, added expertise and yield
  - An experiment started in 1984, since 1989 managers are:
    - Chandler Asset Management
    - Public Financial Management (now via CAMP)

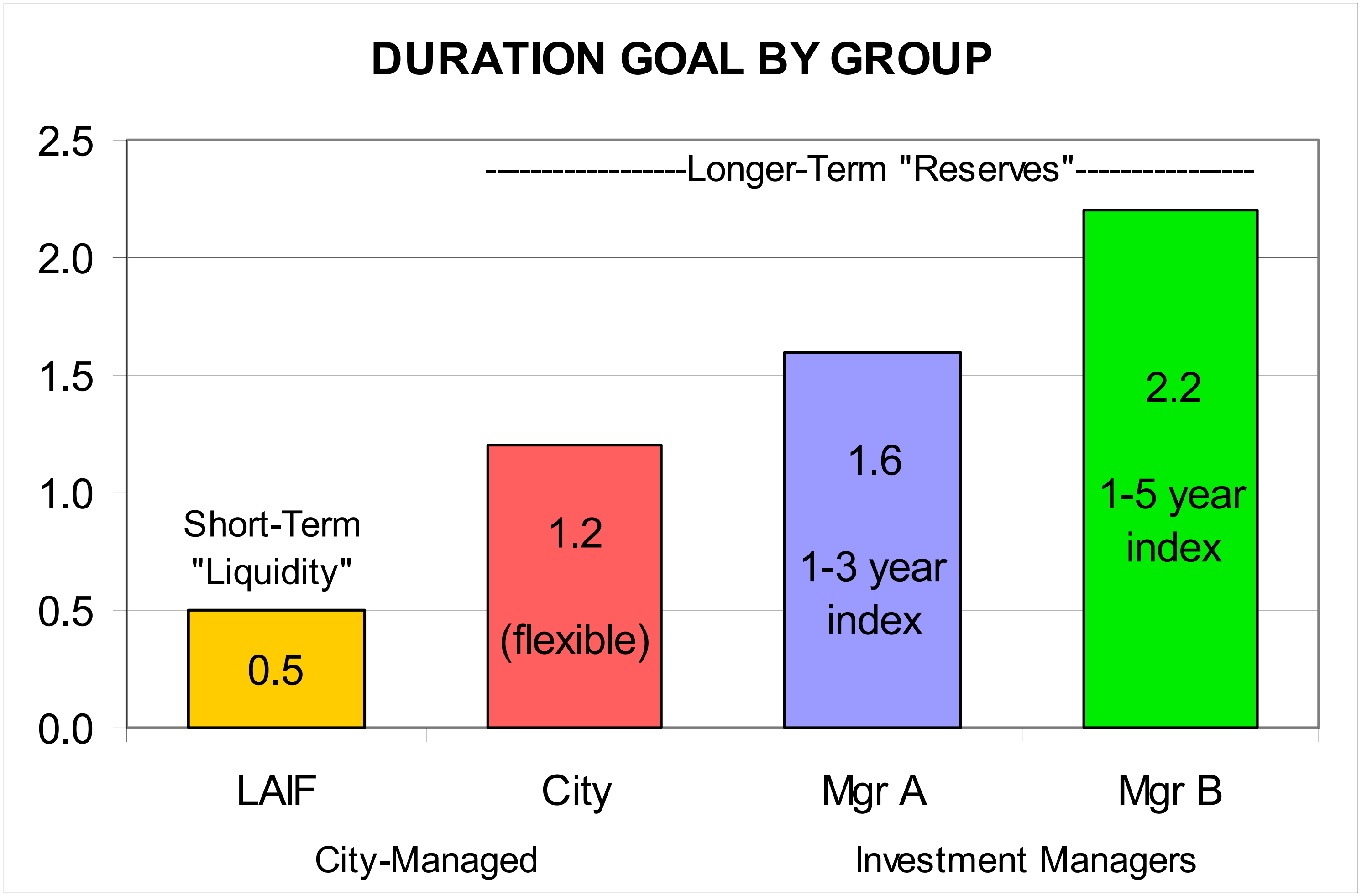
In 1997 City Sought Rational Basis for Restructuring Portfolio

- Safety is paramount, but position on Liquidity-Yield spectrum based on local needs & practice
- City's investment approach historically conservative
  - 75% at 0.5 duration (City & LAIF), 25% at 1.6 (managers)
- Higher duration increases yields, but also increases market risk, more sensitive to interest rate changes

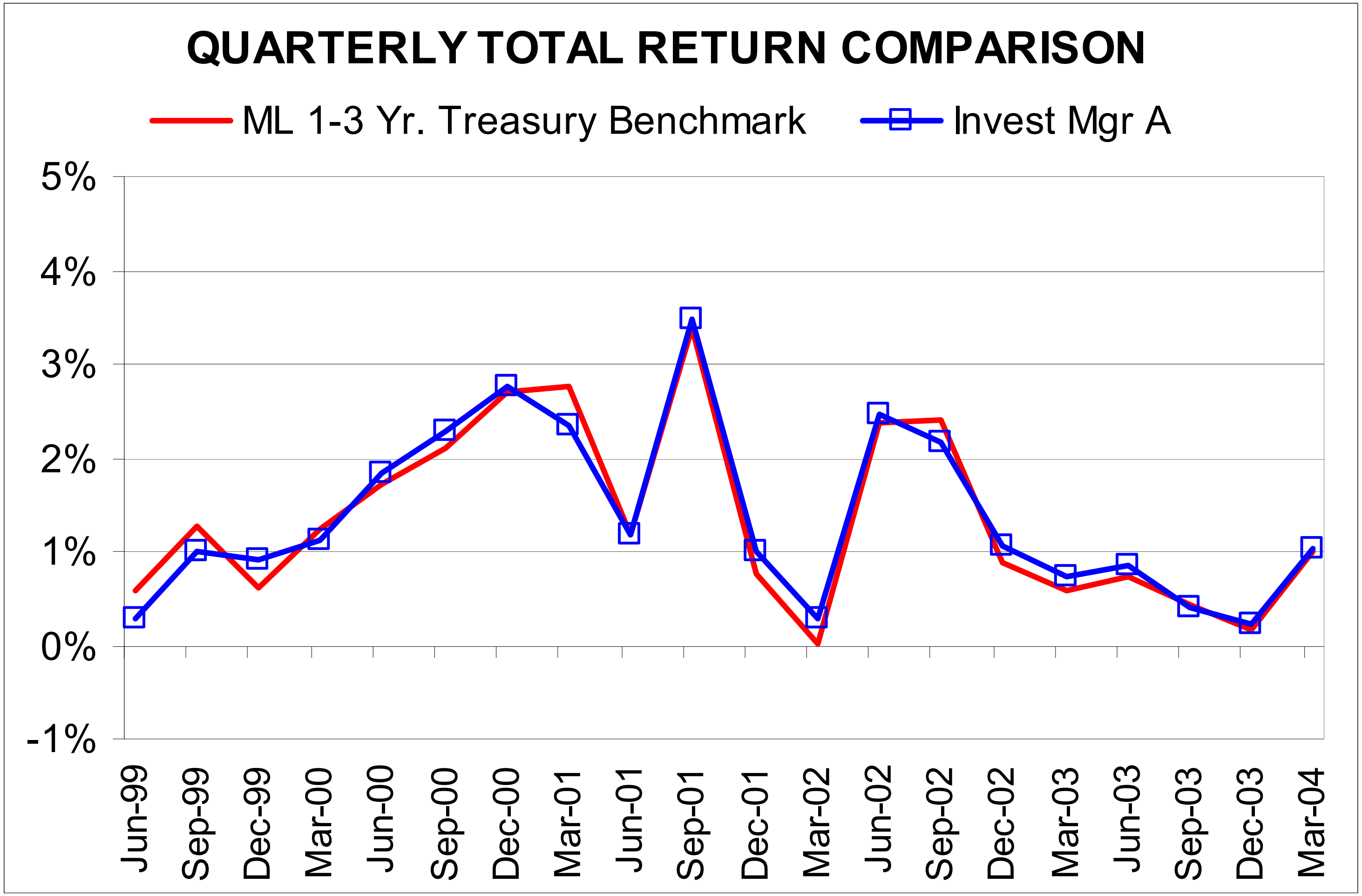
Investing for "Smart Growth"

- Diversify market risk by using different investment managers, and assigning different roles
  - Varies maturities, instruments, investment approaches
- Identify short-term cash flow needs ($30M in 1997) and leave that with LAIF ("liquidity")
- Assign specific duration targets for investment of remaining funds ("reserve")
  - Investment managers tied to benchmark performance indices
  - One manager assigned higher duration
  - City to manage remainder, between duration of LAIF and investment managers

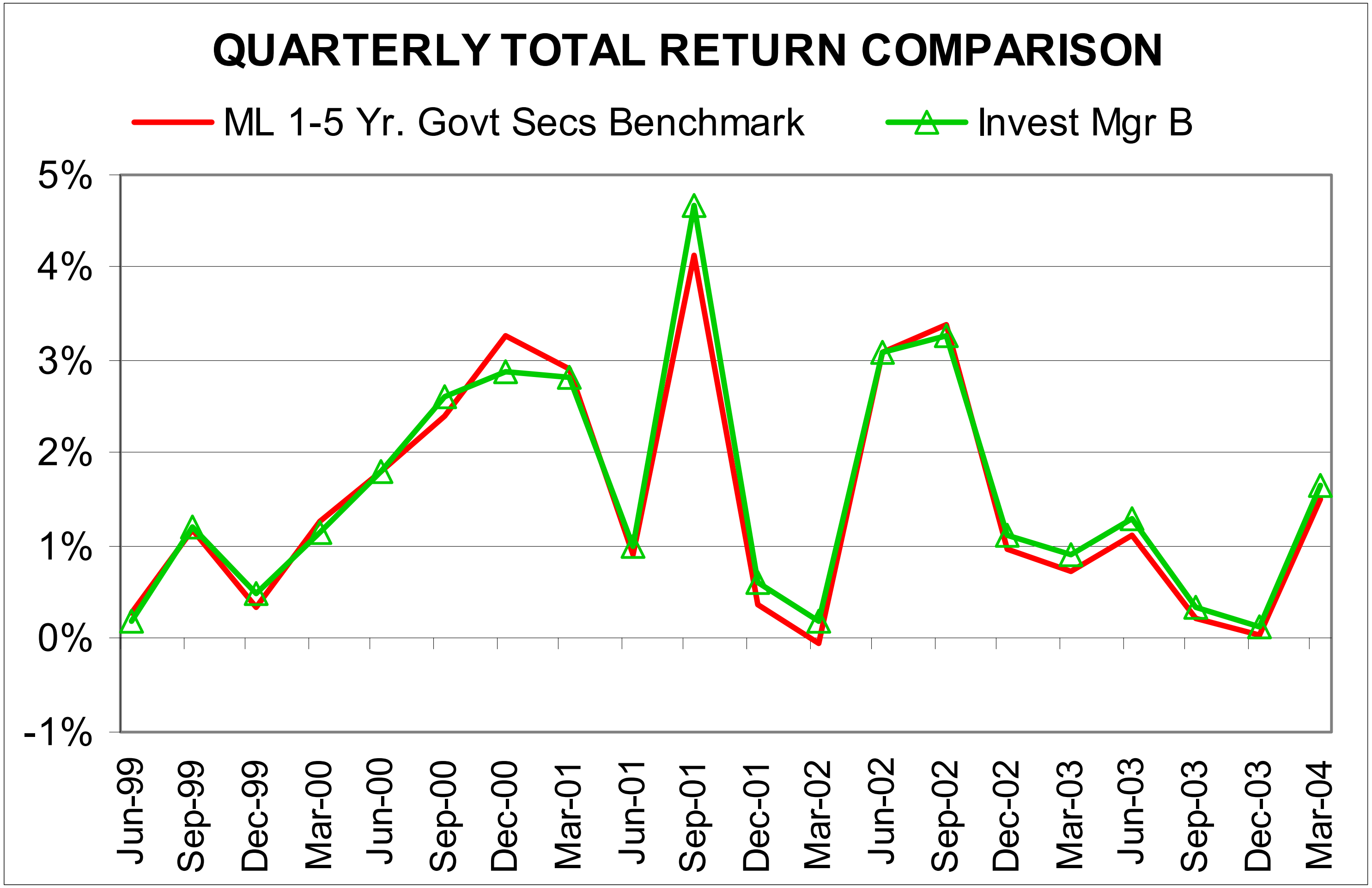
Portfolio Effectively Has Four Managers, Allocated by Duration



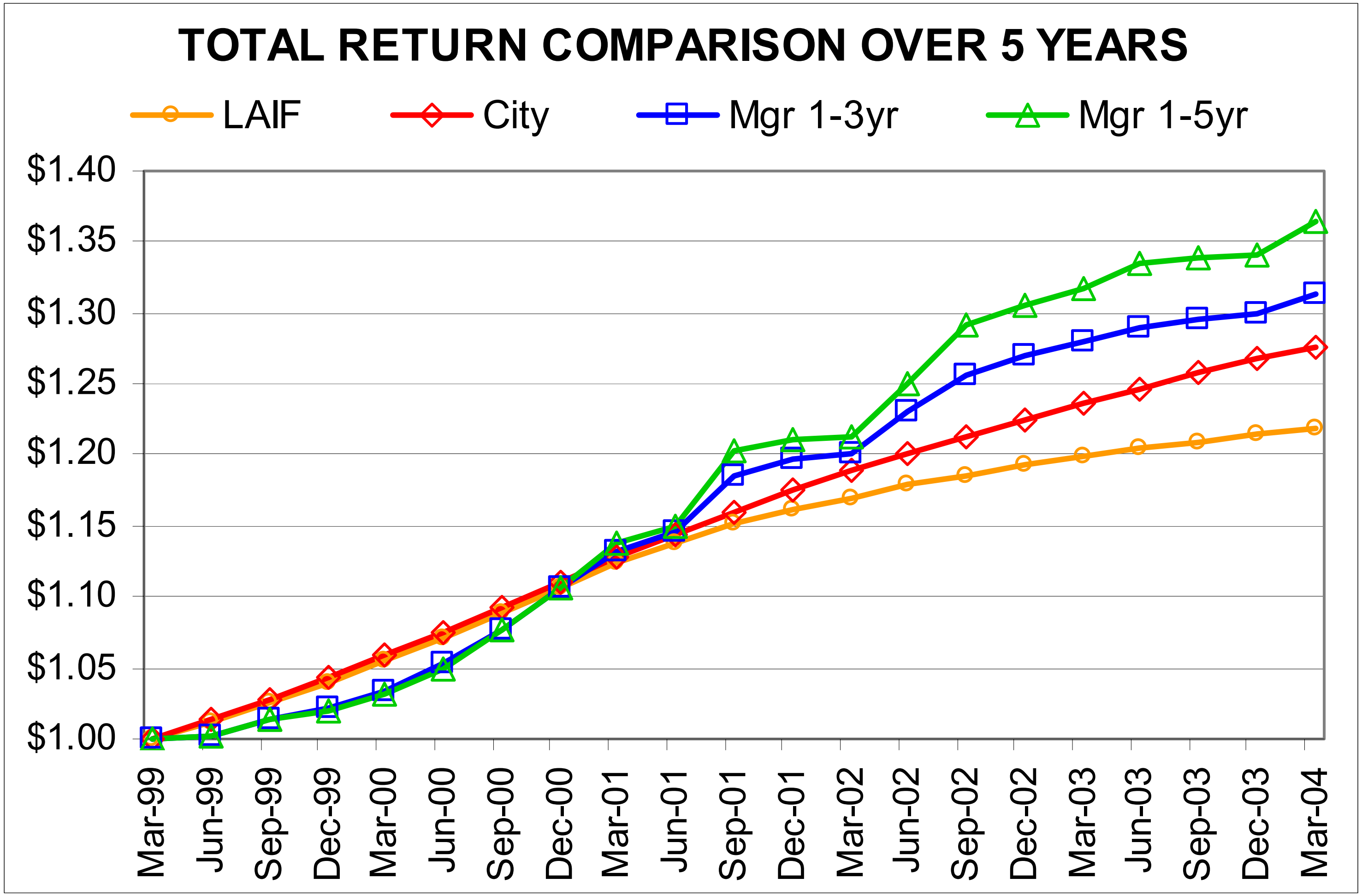
Performance of 1.6 Duration Closely Matches 1-3 Year Treasury Index



Performance of 2.2 Duration Closely Matches 1-5 Year Government Index



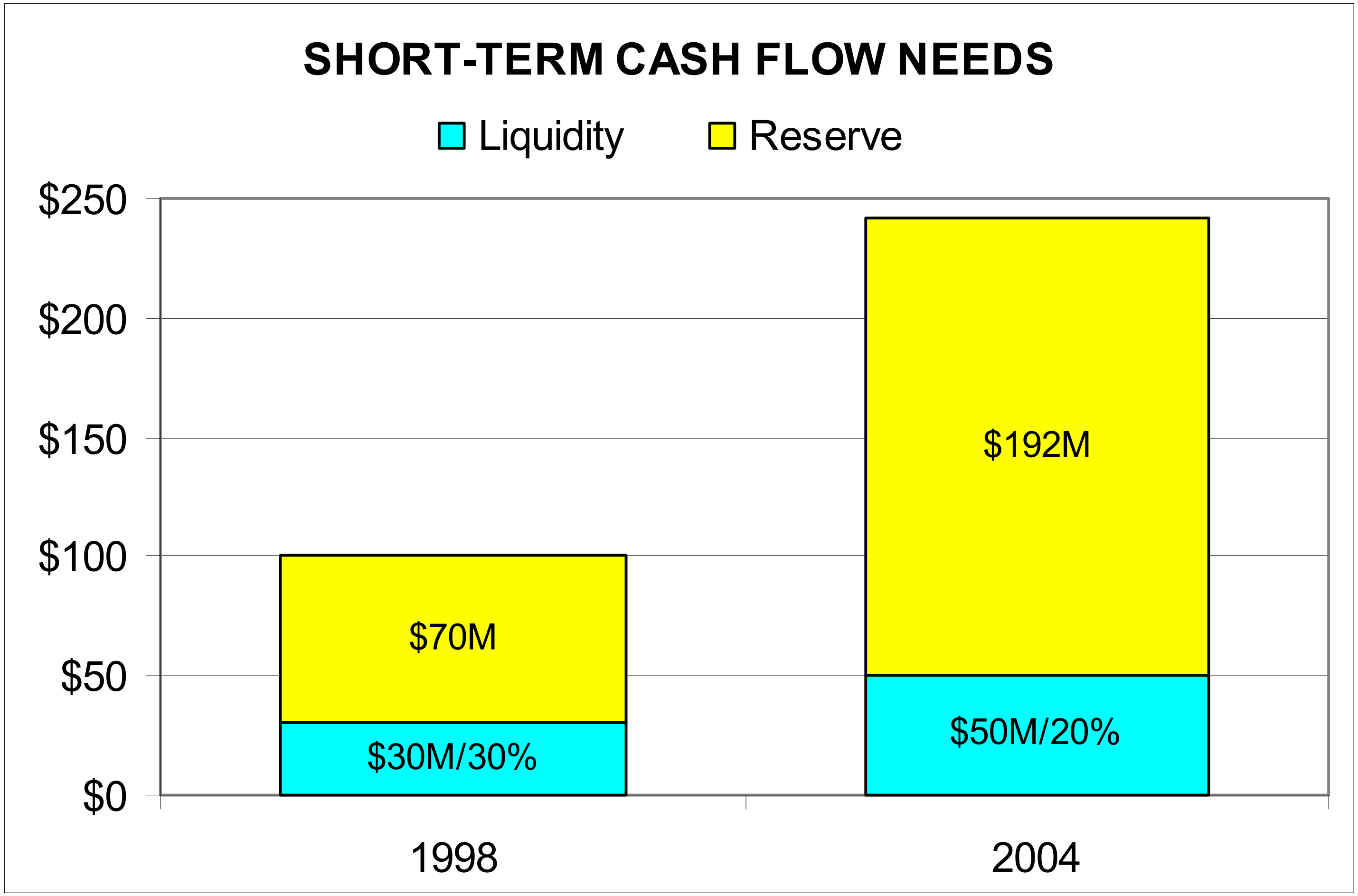
Higher Duration Portfolios Have Higher Returns Over Time



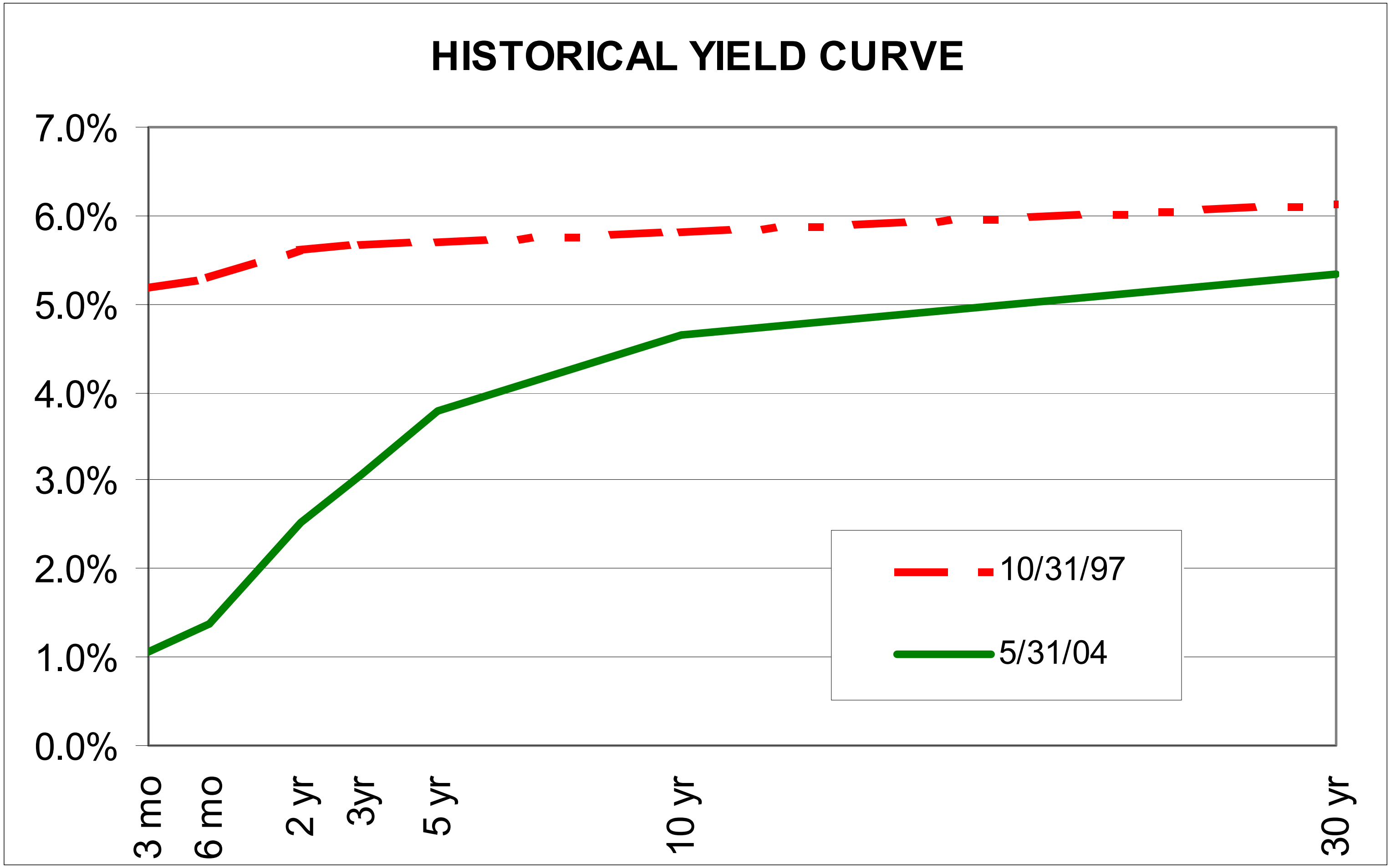
Adapting to Changes Since 1997

- Larger portfolio size and cash flow needs
- Positive versus flat yield curve
- Lower rates
- LAIF average maturity shorter and yield lower

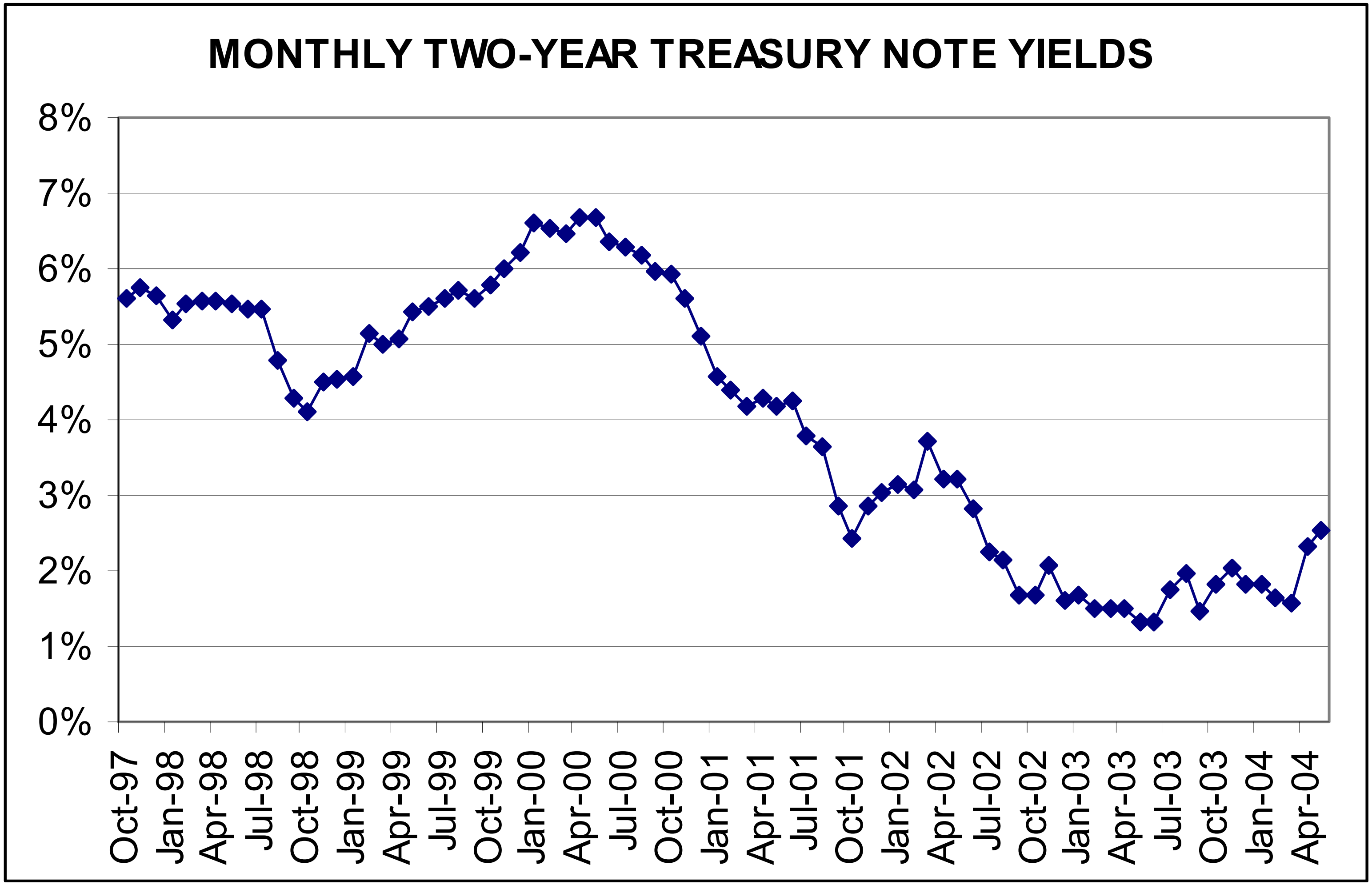
City's Portfolio Much Larger Due to Pay-as-You-Go Capital Funding Policy



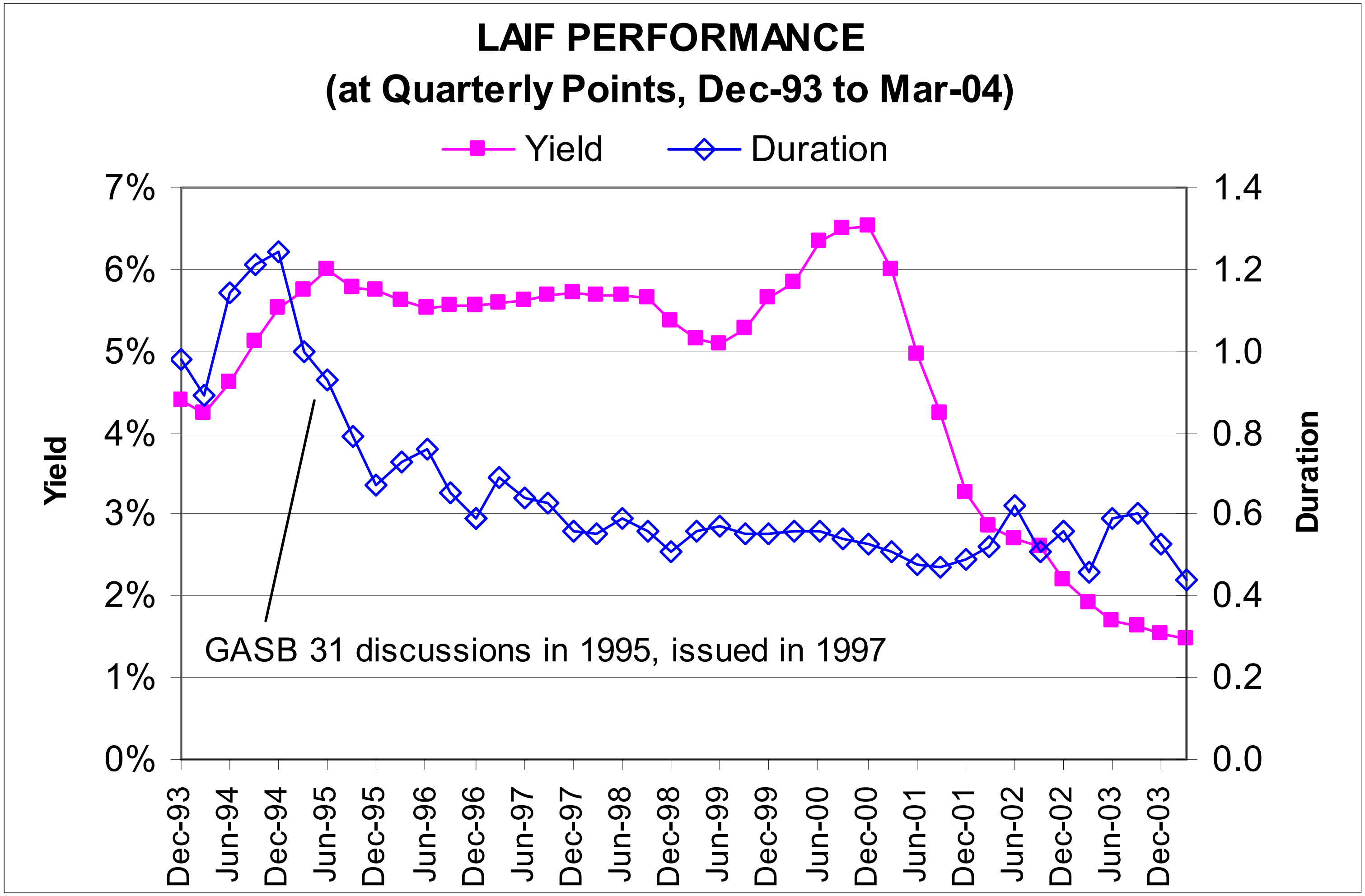
Significant Change in Yield Curve



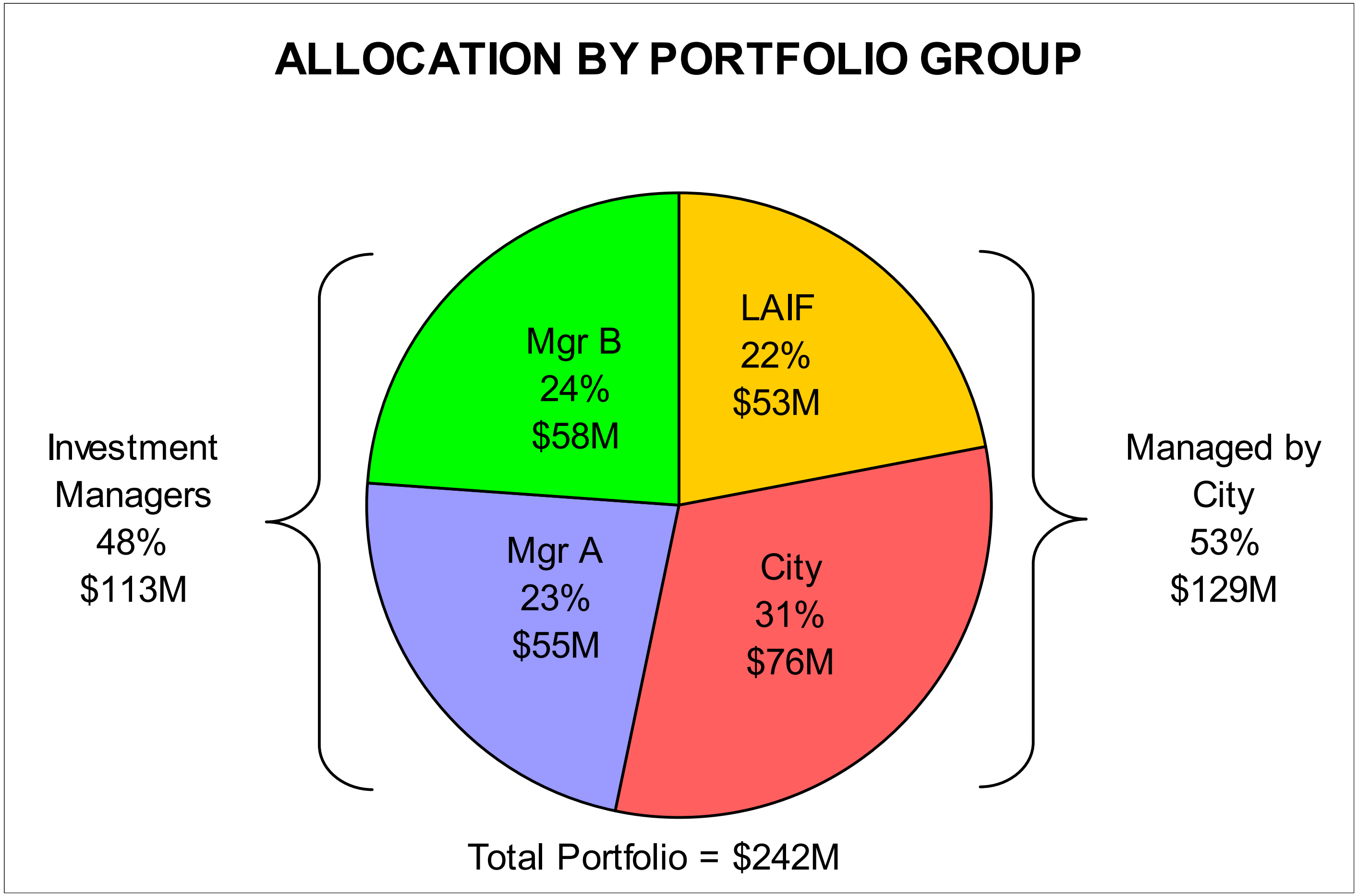
Steady Decline in Rates



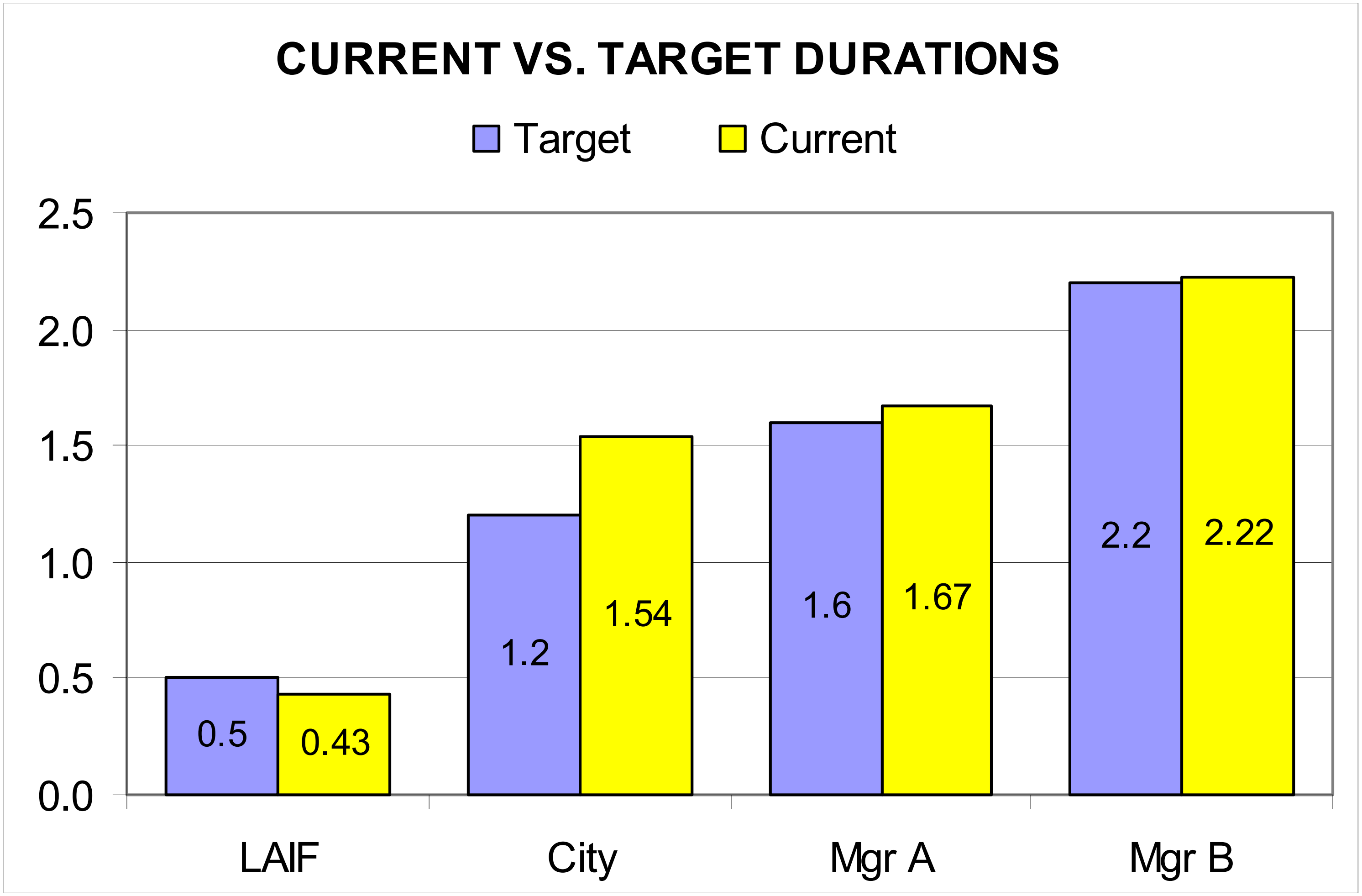
LAIF: Shorter Maturity, Lower Yields



Allocation Today Reflects Balance Between Four Investment Groups



Investment Managers Close to Target, City Extending Duration



Net Impact on Interest Income Varies With Economic Situation & Portfolio

1997
Higher rates, flat yield curve, smaller portfolio

ACTUAL:

	$ in Mil.	Duration	YTM
City/LAIF	$58.5	0.5	5.66%
Inv Mgrs	$25.7	1.6	5.82%
Total	$84.2		5.71%
	$4.8	interest	

"MODEL" PORTFOLIO (OCT-97):

	$ in Mil.	Duration	YTM
LAIF	$30.0	0.5	5.65%
City	$28.5	1.2	5.77%
Mgr A	$5.3	1.6	5.82%
Mgr B	$20.4	2.2	6.22%
Total	$84.2		5.84%
	$4.9	interest	
	$0.1	gain	

*YTM is net of investment manager fees

2004
Lower rates, positive yield curve, much larger portfolio

CONTINUED 1997 PRACTICE:

	$ in Mil.	Duration	YTM
City/LAIF	$168.6	0.5	1.50%
Inv Mgrs	$74.0	1.6	2.20%
Total	$242.6		1.71%
	$4.2	interest	

ACTUAL (MAY-04):

	$ in Mil.	Duration	YTM
LAIF	$53.0	0.43	1.43%
City	$76.1	1.54	2.42%
Mgr A	$55.4	1.67	2.26%
Mgr B	$58.1	2.22	3.42%
Total	$242.6		2.41%
	$5.8	interest	
	$1.7	gain	

*YTM is net of investment manager fees

Investing New Funds in an Increasing Interest Rate Environment

- Set interest rate targets and phase in by systematically investing every month as rates reach target level
- Example for investing $10 million from March-May 2004:

Amount to be Invested	Target Yield for 2-yr US Treasury	Time Target
$2.5 million	1.70%	1 month
$2.5 million	1.80%	2 months
$2.5 million	1.90%	3 months
$2.5 million	2.00%	4 months

Adapting to Interest Rate Trends, Investment Outcome Exceeded Plan

Yield on 2-year U.S. Treasury Note January 1, 2004 – June 2, 2004

Cutting Your Losses

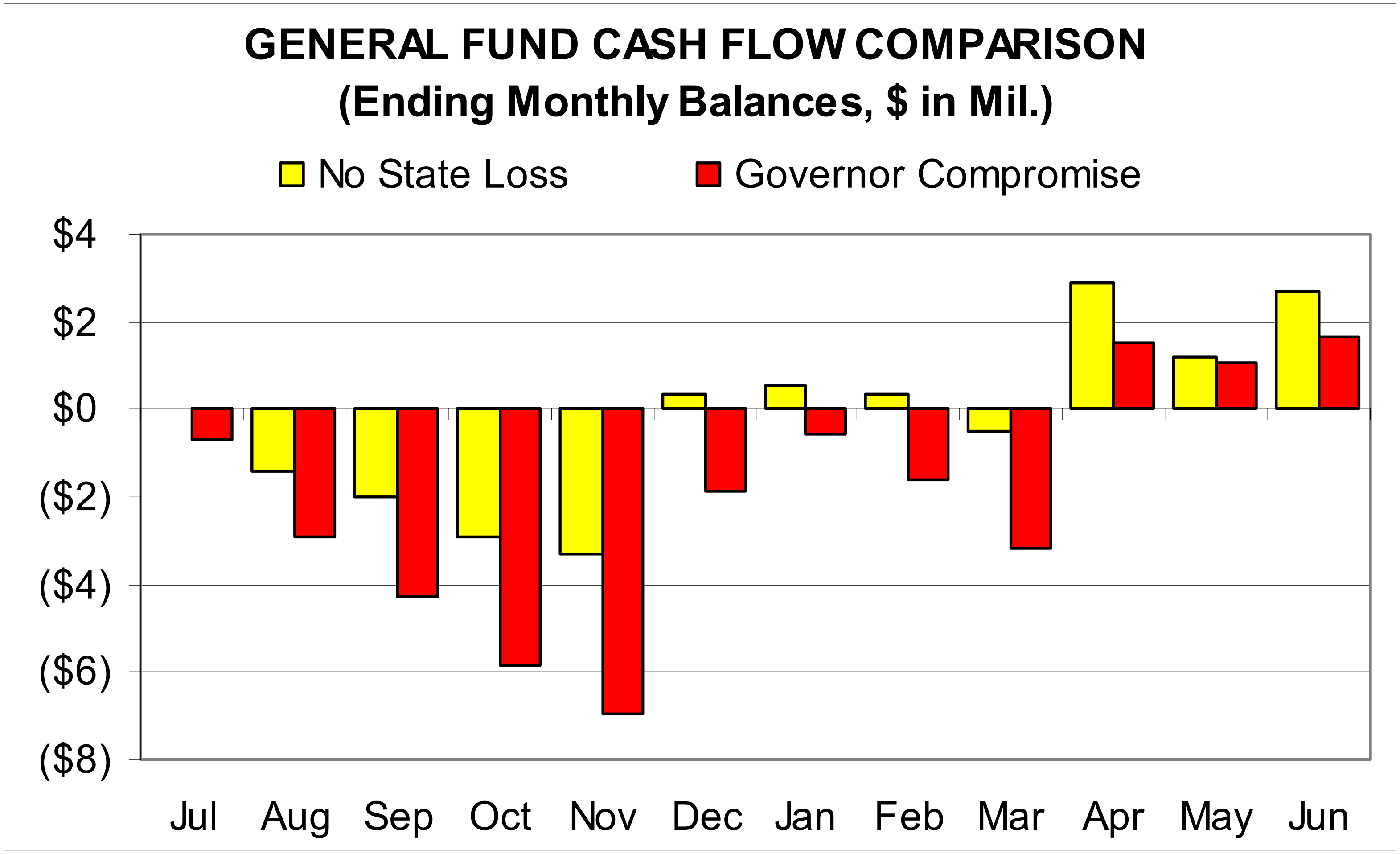
- As rates go up, value of current portfolio drops
- Prepare your Council for occasional “strategic losses”
- Fairfield Investment Policy language:

“Sales prior to maturity are permitted. It is also recognized that in a changing interest rate environment, it may be financially advantageous to sell investments at a book value loss in order to reinvest into a more profitable security.”

Three Major Cash Flow Changes in Store for 2004/05

- Triple Flip
  - Quarter-cent sales tax to be paid using property tax schedule, using prior year estimate
  - First-year transition
- VLF backfill swap for property tax
  - Governor's compromise proposal
- Additional ERAF loss
  - Loss basis determined by cities, counties, districts
- Short-term pain for long-term gain…
- Fairfield example

’04/05 Shortfalls Likely Double That With No Triple Flip, Tax Swaps



Comparing Governor's Plan Impact on Major Revenue Sources

Governor:	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Totals
Property Tax	$0.0	$0.0	$0.0	$0.0	$0.0	$6.5	$0.0	$0.0	$0.0	$6.2	$0.0	$0.3	$13.1
Sales Tax	0.9	1.2	1.3	0.9	1.2	1.5	1.0	1.4	1.2	0.8	1.0	1.5	14.0
ST Backfill	0.0	0.0	0.0	0.0	0.0	0.0	1.9	0.0	0.0	0.0	1.9	0.0	3.8
VLF	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.8
Other	3.0	2.4	2.2	3.5	2.6	1.9	3.0	2.4	1.9	3.5	2.3	2.6	31.3
Total Revenue	4.0	3.6	3.6	4.4	3.9	10.0	6.0	3.9	3.2	10.6	5.3	4.5	63.0
Total Expense	4.7	5.8	5.0	6.0	4.9	5.0	4.7	4.9	4.8	5.9	5.8	3.9	61.4
Net Rev(Exp)	(0.7)	(2.2)	(1.4)	(1.6)	(1.1)	5.0	1.3	(1.1)	(1.6)	4.7	(0.5)	0.6	1.7
Ending Balance	(0.7)	(2.9)	(4.3)	(5.9)	(6.9)	(1.9)	(0.6)	(1.6)	(3.2)	1.5	1.0	1.7	

No Cuts:	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Totals
Property Tax	$0.0	$0.0	$0.0	$0.0	$0.0	$4.4	$0.0	$0.0	$0.0	$4.2	$0.0	$0.2	$8.8
Sales Tax	1.2	1.5	1.6	1.1	1.5	1.9	1.3	1.7	1.5	1.0	1.3	1.9	17.6
ST Backfill	-	-	-	-	-	-	-	-	-	-	-	-	-
VLF	0.5	0.5	0.6	0.4	0.4	0.4	0.6	0.6	0.4	0.7	0.5	0.6	6.2
Other	3.0	2.4	2.2	3.5	2.6	1.9	3.0	2.4	1.9	3.5	2.3	2.6	31.3
Total Revenue	4.6	4.4	4.4	5.1	4.5	8.6	4.9	4.7	3.9	9.3	4.1	5.4	64.0
Total Expense	4.6	5.8	5.0	6.0	4.9	5.0	4.7	4.9	4.8	5.9	5.8	3.9	61.2
Net Rev(Exp)	(0.0)	(1.4)	(0.6)	(1.0)	(0.4)	3.7	0.2	(0.2)	(0.9)	3.4	(1.7)	1.5	2.7
Ending Balance	(0.0)	(1.4)	(2.0)	(2.9)	(3.3)	0.4	0.5	0.4	(0.5)	2.9	1.2	2.7	

Summary

- Structure your portfolio for smart investment growth
  - Meet short-term cash flow needs (“liquidity”)
  - Stratify “reserve” funds by duration to minimize market risk, link to benchmarks to instill investment discipline
  - Continually review performance
- With increasing rates, watch market value and reinvestment opportunities
  - Some short-term losses are worth taking for long-term gain
- Be aware cash flow in 2004/05 is likely to worsen